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Tax & Legal Flash

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Deductibility of VAT on indemnity payments made

The VAT Act allows a vendor to deduct VAT equal to the tax fraction of any payment made by the vendor to indemnify another person in terms of any contract or insurance. However, it requires that the contract of insurance is a taxable supply (i.e. a supply on which VAT is chargeable, either at the zero or standard date). This requires that the insurance activity be an "enterprise" activity in terms of which services are supplied to any person *for consideration* (our emphasis).

The recent case (*Commissioner for the South African Revenue Service v Capitec Bank Limited (94/2021) [2022] ZASCA 97 (21 June 2022)),* on appeal from the Tax Court, related to a deduction of input tax in respect of indemnity payments made by Capitec relating to loan cover payments made for its unsecured lending business.

The brief background was as follows:

- As part of the provision of credit to customers, Capitec provided loan cover, the proceeds of which were applied to settle or reduce the outstanding loan amount due to Capitec in the event of the customer's death or retrenchment;
- No additional charge was levied for the loan cover provided to customers in addition to the monthly service fee and interest;
- Loan cover was underwritten by Guardrisk Life Limited whereby Capitec is insured and may claim under the policy on account of the death or retrenchment of the borrower;
- Capitec essentially insured itself against the unpaid amount, resulting in the loan being paid in full and Capitec not suffering a loss of credit; and
- Capitec made input tax deductions calculated on the tax fraction of payments made under the loan cover on the basis that the loan cover was taxable through other taxable fees it charged customers.

The principle question the court had to answer in this case was whether the loan cover supplied was an enterprise activity and, in turn, a taxable supply. If affirmative, the deduction would be permitted.

The Tax Court held that the fee income, which is charged over and above the interest charge is part of the consideration payable for the provision of credit and that the loan cover promotes and is made in the course of the enterprise which includes making of taxable supplies. The VAT was therefore held to be deductible.

However, the SCA carefully considered, through a review of the loan agreements entered into with customers, that the loan cover was, in fact, supplied for no consideration. These agreements stated that no credit life insurance or optional insurance is charged. An extract from the agreement confirms that the charge is included in the interest rate charged. Given regulated industry of granting credit, Capitec could only charge fees in terms of National Credit Act provisions and therefore could not bundle with regulated fees. Therefore, since there is no consideration, the supply of loan cover could not be said to be an enterprise activity.

It was therefore held that the loan cover was supplied in the course of making exempt supplies since the policies ensured recovery of the credit given to its customers, and the deduction not permitted. The appeal from SARS therefore succeeded. Although the appeal succeeded, the court ruled in favour of Capitec in respect of late payment penalties – no order was made as to the imposition of understatement penalties.

The take-away from this case is that the classification of an activity is an “enterprise” activity should be evaluated with a sufficient degree of diligence. In addition, the regulatory nature of the industry within which a vendor operates should also be taken into account. The downfall for Capitec in this case was essentially that the fees charged under credit arrangements are highly regulated and therefore could not be argued that consideration was received.

Should you have any queries or require any assistance relating to the above, please do not hesitate to contact us.

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Kind regards

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